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RECOGNITION OF REVENUES AND EXPENSES IN THE DEFENSE
BUSINESS MANAGEMENT SYSTEM

Report No. D-2001-108

April 27, 2001

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Abstract This report is the third in a series of reports on reliability of information supporting the Navy Working Capital Fund Financial Statements and related internal controls. The previous reports dealt with inventory revaluation and our endorsement of the Naval Audit Service disclaimer of opinion on the FY 2000 Navy Working Capital Fund Financial Statements. We performed the audit in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, which requires the DoD to provide audited financial statements to the Office of Management and Budget. The Supply Management activity group is the largest of the nine activity groups in the Navy Working Capital Fund, and it reported \$5.4 billion in revenue and \$5.5 billion in expenses for FY 2000. The Supply Management activity group used the Defense Business Management System (DBMS) to account for \$304 million of revenue from services provided and operating expenses of \$1.2 billion. Approximately \$413 million of the total operating expenses were personnel related and excluded from our review. The remaining \$760 million of operating expenses were the types of expenses tested by our audit. Revenue from sale of inventory and related cost of goods sold were accounted for in other accounting systems.		
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Acronyms

BMR	Business Management Redesign
DBMS	Defense Business Management System
DFAS	Defense Finance and Accounting Service
FISC	Fleet Industrial Supply Center
NAVICP	Naval Inventory Control Point
WCF	Working Capital Fund



INSPECTOR GENERAL
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April 27, 2001

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE
NAVAL INSPECTOR GENERAL

SUBJECT: Audit Report on Recognition of Revenues and Expenses in the Defense
Business Management System (Report No. D-2001-108)

We are providing this report for information and use. We conducted the audit in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. We considered management comments on a draft of this report in preparing the final report.

Comments on the draft of this report conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Mr. Marvin L. Peek at (703) 604-9587 (DSN 664-9587) (mpeek@dodig.osd.mil) or Mr. Joel Chaney at (216) 522-6091 (DSN 580-6091), extension 235 (jchaney@dodig.osd.mil). See Appendix B for the report distribution. The audit team members are listed inside the back cover.

A handwritten signature in dark ink, appearing to read "Thomas F. Gimble", is positioned above the printed name.

Thomas F. Gimble
Acting
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. D-2001-108

(Project No. D2000FC-0279.003)

April 27, 2001

Recognition of Revenues and Expenses in the Defense Business Management System

Executive Summary

Introduction. This report is the third in a series of reports on reliability of information supporting the Navy Working Capital Fund Financial Statements and related internal controls. The previous reports dealt with inventory revaluation and our endorsement of the Naval Audit Service disclaimer of opinion on the FY 2000 Navy Working Capital Fund Financial Statements. We performed the audit in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, which requires the DoD to provide audited financial statements to the Office of Management and Budget. The Supply Management activity group is the largest of the nine activity groups in the Navy Working Capital Fund, and it reported \$5.4 billion in revenue and \$5.5 billion in expenses for FY 2000. The Supply Management activity group used the Defense Business Management System (DBMS) to account for \$304 million of revenue from services provided and operating expenses of \$1.2 billion. Approximately \$413 million of the total operating expenses were personnel related and excluded from our review. The remaining \$760 million of operating expenses were the types of expenses tested by our audit. Revenue from sale of inventory and related cost of goods sold were accounted for in other accounting systems.

Objectives. Our overall objective was to determine the reliability and effectiveness of processes and procedures used to compile and prepare the Navy Working Capital Fund financial statements. The objectives of this phase of the audit were to review procedures and controls over the recognition of revenue and expenses for the Navy Working Capital Fund within the DBMS, and to evaluate the reliability of that financial information provided to the Defense Finance and Accounting Service (DFAS) Cleveland for inclusion in the Navy Working Capital Fund financial statements. We reviewed management controls and compliance with laws and regulations as they related to the audit objectives. See Appendix A for a discussion of the audit process.

Results. The recording of revenues, accounts receivable, expenses and accounts payable in DBMS did not comply with DoD accounting policy. Specifically,

- DFAS Columbus prematurely recorded revenue and accounts receivable in general ledger accounts based on obligations rather than actual earnings. Approximately \$3.6 million (90 percent) of the \$4 million in revenue transactions reviewed was recognized prematurely (finding A).

- The Fleet Industrial Supply Center Puget Sound and Naval Inventory Control Point Mechanicsburg did not always record expenses and accounts payable when material or services were received. In some cases, expenses were recognized when the related disbursement was recorded in the DBMS and in other cases, the expense was recorded when funds were initially obligated. Approximately \$1.5 million (48 percent) of the \$3.1 million of expense transactions reviewed was not recognized during the month that the expense was incurred (finding B).

We reviewed sample transactions at 2 of the 12 Navy Working Capital Fund organizations using DBMS. However, with such large percentages of revenue and expenses not recognized in the proper accounting period, we are concerned about the reliability of \$304 million in revenue and \$760 million in expenses (excluding payroll-related costs) reported from the DBMS for the FY 2000 financial statements of the Supply Management activity group of the Navy Working Capital Fund. We identified material control weaknesses at DFAS Columbus and the two Navy Working Capital Fund offices visited. See Appendix A for details regarding management controls within DBMS over the recognition of revenues and expenses.

Summary of Recommendations. We recommend that the Director, DFAS, with assistance from the Assistant Secretary of the Navy, Financial Management and Comptroller, establish interim procedures to recognize revenue in the DBMS when earned and that DFAS ensure that the new Business Management Redesign system has appropriate procedures and controls to correctly recognize revenue when earned. We also recommend that the Commander, Naval Supply Systems Command, establish procedures and controls to ensure that personnel provide sufficient information to the appropriate Navy accounting offices to record expenses and accounts payable in the period incurred. In addition, we recommend that the Director, DFAS, require that the Business Management Redesign system generate management reports to help monitor the timeliness of the recording of expenses and accounts payable.

Management Comments. DFAS and the Navy both concurred with the recommendations. DFAS will work with the Navy to revise current practices or to develop interim procedures to ensure revenues are properly recorded in the correct accounting period. DFAS has included procedures and controls in the Business Management Redesign system to recognize revenue when earned and produce management reports to monitor the timeliness of recording expenses and accounts payable. The Navy will establish procedures and controls to ensure its personnel provide sufficient information to appropriate Navy accounting offices to record expenses and accounts payable in the period incurred.

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Background

DoD is required by Public Law 101-576, the “Chief Financial Officers Act of 1990,” November 15, 1990, as amended by Public Law 103-356, the “Federal Financial Management Act of 1994,” October 13, 1994, to submit to the Office of Management and Budget annual financial statements that have been audited by the Inspector General, DoD. This report is the third in a series of reports on the Navy Working Capital Fund (WCF) financial statements. Report No. D-2001-022, “Inventory Revaluation for the Navy Working Capital Fund by the Naval Supply Systems Command,” December 18, 2000, discusses erroneous accounting entries to revalue inventory recorded by the Naval Supply Systems Command. Report No. D-2001-057, “Inspector General, DoD, Oversight of the Naval Audit Service Audit of the FY 2000 Navy Working Capital Fund Financial Statements,” February 21, 2001, endorses the Naval Audit Service disclaimer of opinion on the financial statements. This report discusses procedures and controls over the recognition of revenue and expenses in the Defense Business Management System (DBMS) and the reliability of the financial information that the DBMS provides to the Defense Finance and Accounting Service (DFAS) Cleveland for inclusion in the Navy WCF financial statements.

Navy Working Capital Fund. The Navy WCF finances nine primary activity groups, which provide support to the Navy and other authorized customers. For FY 2000, the Navy WCF reported \$25 billion in assets, \$6 billion in liabilities, \$13.7 billion in revenue, and \$13.6 billion in expenses. The Supply Management activity group, the largest of the nine groups, acquires, stocks, stores, and issues inventory in support of Fleet and Marine forces, shore activities, and other DoD and Federal Activities. This activity group reported \$16.6 billion in assets, \$1.6 billion in liabilities, \$5.4 billion in revenue, and \$5.5 billion in expenses.

Defense Business Management System. The Navy WCF utilized the DBMS to account for revenue from services provided and operating expenses for the Supply Management activity group. In FY 2000, the DBMS reported for the Supply Management activity group revenue of \$.3 billion from services provided and \$1.2 billion in operating expenses. Approximately \$.4 billion of the operating expenses were personnel related expenses, which are excluded from the scope of our audit.

The DBMS, developed and maintained by DFAS, is a resource management and accounting system. In addition to the Navy WCF, the DBMS provides accounting support to the Air Force Material Command, Defense Commissary Agency, Defense Contract Audit Agency, DFAS, and the Defense Logistics Agency. DBMS has been designated as a legacy system and, as such, there is no funding available to make system changes.

DFAS Columbus established a project office to develop an integrated financial management information system referred to as the Business Management

Redesign (BMR) system to replace the DBMS. The BMR would incorporate the functionality of DBMS and its related suite of systems. The application is designed to implement an integrated financial management information system for DFAS with reduced operating costs and improved system performance. Commercial off-the-shelf procurement was selected as the acquisition strategy. Approval for systems development and demonstration, Milestone B, is expected in April 2001, and the project office anticipates awarding a contract at the end of May 2001. Initial operational capability of the system, for DFAS programs, is scheduled for October 2002. An initial operational capability for Navy programs has not been established.

Defense Finance and Accounting Service. DFAS Columbus performed accounting services and prepared financial reports and financial statements for DoD agencies and the Military Services. DFAS Columbus also processed employee travel payments, performed cash reconciliations, and processed interfund and reimbursable billings. In addition, the Accounting Division at DFAS Columbus was the administrator for the DBMS. DFAS Cleveland received information from the DBMS and other feeder systems and compiled the FY 2000 financial statements for the Navy WCF.

Objectives

Our overall objective was to determine the reliability and effectiveness of processes and procedures used to compile and prepare the Navy WCF financial statements. The objectives of this phase of the audit were to review procedures and controls over the recognition of revenue and expenses for the Navy WCF within the DBMS, and to evaluate the reliability of the financial information provided to DFAS Cleveland for inclusion in the Navy WCF financial statements. We reviewed management controls and compliance with laws and regulations as they related to the audit objectives. See Appendix A for a discussion of the scope, methodology, management control program review, and prior audit coverage.

A. Recognition of Revenue and Accounts Receivable

DFAS Columbus prematurely recorded revenue and accounts receivable in the general ledger accounts for the Navy WCF. Of the \$4 million in revenue transactions reviewed, \$3.6 million (90 percent) was recognized prematurely. This occurred because the DBMS was programmed to record earnings (revenue) from reimbursable orders based on the obligation of funds to perform the work rather than cost incurred to complete the work. As a result, only 10 percent of revenue transactions sampled were properly recorded. Therefore, we are concerned about the reliability of the \$304 million in revenue that the DBMS reported to DFAS Cleveland for inclusion in the FY 2000 financial statements for the Navy WCF.

Criteria for Recognizing Revenue and Accounts Receivable

The “DoD Financial Management Regulation,” DoD Regulation 7000.14-R, volume 11B, “Reimbursable Operations,” December 1994, requires revenue and associated costs be recognized in the same accounting period. Volume 4, “Accounting Policy and Procedures,” August 17, 2000, requires accounts receivable to be recorded based on completion of the acts that entitle the DoD to collect amounts owed it.

The Federal Accounting Standards Advisory Board “Statement of Federal Financial Accounting Standards Number 7,” April 1996, states revenue from exchange transactions should be recognized when goods or services are provided to the public or another Government entity at a price.

The “Guide to Federal Requirements for Financial Management Systems,” chapter 5, “Revenue and Accounts Receivable,” April 14, 1998, states that the system must recognize revenue from exchange transactions when goods or services are sold to the public or another Government entity. The guidance also establishes that the system must recognize revenue when services are performed for the public or another Government entity.

Recording Revenue and Accounts Receivable in DBMS

The DBMS was programmed to recognize revenue when obligations that cited a Reimbursable Job Order Number were established in the DBMS, such as when contracts for services or material were awarded. We reviewed 105 revenue transactions totaling \$4 million out of \$9.3 million in revenue reported during May 2000 for the Fleet Industrial Supply Center (FISC) Puget Sound and the

Naval Inventory Control Point (NAVICP) Mechanicsburg. Results showed that \$3.6 million (90 percent) of the revenue transactions reviewed were recognized based on obligations rather than completion of the job order.

Early Recognition of Revenue and Accounts Receivable. DBMS prematurely recognized earnings (revenue) for 47 of the 105 sample transactions. Of \$4 million of revenue transactions reviewed, \$3.6 million (90 percent) was recorded as revenue and accounts receivable before work was performed or services were provided. DBMS recognized revenue prematurely because DBMS was programmed to record earnings based on an obligation with a matching Job Order Number. An obligation is an agreement that will result in outlays of budgetary resources, immediately or in the future. However, an obligation does not establish a cost or support the receipt of goods or services. Therefore, an obligation should not be the basis for the recording of an earning. Revenue should be recognized and recorded based on the associated costs that support the receipt of the goods or service.

Of the remaining 58 earnings transactions, 47 earnings transactions were related to personnel costs that were recognized based on automatic interface with the personnel pay system. These transactions were recorded in the proper period. We were not able to determine the basis for the remaining 11 transactions because of insufficient audit trails in DBMS. DFAS Columbus personnel were not able to explain or identify the basis for those recorded earnings.

The DBMS did not readily identify the amount of revenue recorded automatically based on obligations. Also, because our audit tests were not performed at the end of FY 2000, we are not able to estimate what portion of the \$304 million in revenue reported for the Supply Management activity group in the DBMS was misstated on the FY 2000 financial statements. However, based on the result of our review, we are concerned about the reliability of the financial data for revenue and accounts receivable provided to DFAS Cleveland for inclusion in the monthly reports and yearly Chief Financial Officer financial statements.

System Capabilities for Revenue Recognition. Because the DBMS is a legacy system and scheduled to be replaced by the BMR system, management was not allowed to make costly changes to the system. The systems requirements for the BMR application provide the capability to establish earnings based on unit cost, percentage of completion, time period pro-ratio, or actual cost. Accordingly, we are not recommending modification to the DBMS or the BMR system. However, until the BMR system is fielded, revenue and accounts receivable reported by the DBMS will not be reliable. The BMR system provides alternative revenue recognition methodologies. We believe that the actual cost method would be the most appropriate methodology for the Navy WCF organizations to adopt.

Recommendations and Management Comments

A.1. We recommend that the Director, Defense Finance and Accounting Service, with assistance from the Assistant Secretary of the Navy, Financial Management and Comptroller, establish interim procedures to recognize revenue recorded in the Defense Business Management System in accordance with the DoD Financial Management Regulation.

DFAS Comments. DFAS concurred and will work with the Navy to revise current business practices or develop interim procedures to ensure that revenues are properly recorded in DBMS in accordance with DoD Regulation 7000.14-R. DFAS Columbus and the Navy will develop a plan of action and milestones to implement the changes by September 30, 2001.

Navy Comments. The Navy concurred in principle and noted that implementation of the interim revenue recognition procedures will depend on workload considerations and the deployment of the BMR.

A.2. We recommend that the Director, Defense Finance and Accounting Service, ensure that the new Business Management Redesign System, when fielded, has appropriate procedures and controls to recognize revenue during the period the revenue was earned.

DFAS Comments. DFAS concurred and indicated that the requirements for the BMR include appropriate procedures and controls to recognize revenue during the period it is earned. The deployment of the Business Management Redesign System has not been determined.

B. Accrual of Expenses and Accounts Payable

FISC Puget Sound and NAVICP Mechanicsburg did not properly accrue expenses in the month they occurred. Of the \$3.1 million in expense and accounts payable transactions reviewed, \$1.5 million (48 percent) were not properly recorded during the month the expense was incurred. Approximately \$1.3 million (42 percent) were recorded at least 1 month after the expense occurred and \$.2 million (6 percent) were recorded before the expenses should have been recognized. In addition, the 2 Navy accounting offices did not have adequate documentation to support the recorded expenses for \$2.3 million of the \$3.1 million in expense transactions sampled. Those conditions occurred because FISC Puget Sound and NAVICP Mechanicsburg had not established procedures and controls to ensure that expenses and accounts payable were recorded when material or services were received based on supporting documentation. Instead, expenses and accounts payable were recognized when disbursements were recorded in the accounting system or when obligations were established. As a result, only 52 percent of expenses sampled were properly recorded in the month incurred. Therefore, we are concerned about the reliability of \$760 million in expenses, excluding personnel costs, that the DBMS reported to DFAS Cleveland for inclusion in the FY 2000 financial statements for the Supply Management activity group of the Navy WCF.

Policy for Recording Expenses and Accounts Payable

DoD Regulation 7000.14-R, volume 4, "Accounting Policy and Procedures," August 2000, chapter 9, "Accounts Payable," establishes policy for the recording of accounts payable by DoD Components. An amount recorded as a liability must be supported by documentation in the form of a receiving report that clearly shows the material was received or the service was performed. In addition, accounts payable should be recorded when the accounting station has received evidence in the form of either an inspection or a receiving report. Chapter 17, "Expenses and Miscellaneous Items" states that costs that apply to an entity's operations for the current accounting period are recognized as expenses of that period.

Operating Expenses of the Supply Management Activity Group

The Navy WCF financial statements for FY 2000 included \$1.2 billion in operating expenses of the Supply Management activity group. DFAS Columbus used the DBMS to account for those operating expenses. Approximately \$413 million of the total operating expenses were personnel related and are excluded from the scope of this review. The remaining \$760 million of operating expenses were the types of expenses tested during our audit.

Operating Expenses Recorded During May 2000. During May 2000, operating expenses totaling \$97.5 million were recorded in the DBMS. Approximately \$35.6 million of the operating expenses were personnel related, while \$61.9 million were related to travel, transportation, materials, services and other expenses. NAVICP Mechanicsburg and FISC Puget Sound (2 of the 12 Navy WCF organizations using DBMS) accounted for \$9.5 million of the \$61.9 million in non-personnel related operating expenses reported during May 2000.

Expense Recognition

We reviewed 101 expense type transactions that NAVICP Mechanicsburg and FISC Puget Sound recorded in May 2000. Those transactions represented \$3.1 million of the \$9.5 million in non-personnel related expenses recorded during May 2000. Approximately \$1.5 million (62 transactions) of the \$3.1 million reviewed (48 percent) were not properly recorded during the month the expense was incurred. Of the 62 transactions, 47 transactions, totaling \$1.3 million, were recorded at least 1 month after the material or service was received. For the remaining 15 transactions the expenses, totaling \$.2 million, were recorded before the material or service was received. The following table shows the type of expenses that the transactions represented.

Expense Recognition by Type

<u>Late Recognition of Expenses</u>		
<u>Document Type</u>	<u>Number of Transactions Represented</u>	<u>Dollar Value of Transactions Represented (in thousands)</u>
Service contracts	24	\$1,132
Material contracts	9	154
Material requisitions	13	3
Training	<u>1</u>	<u>2</u>
Subtotal	47	\$1,291
<u>Premature Recognition of Expenses</u>		
Bulk obligations	2	\$ 175
Travel authorizations	<u>13</u>	<u>24</u>
Subtotal	15	\$ 199
Total expenses recognized late or prematurely	62	\$1,490

Recognition of Expenses After Occurrence. Failure to recognize an expense during the period when goods and services are received violates accrual accounting procedures and results in a misstatement of expenses and accounts payable in the financial statements. Of \$3.1 million in expense transactions reviewed, \$1.3 million (42 percent) of those expenses should have been recorded in a prior month.

Service Contracts. For the 24 transactions involving service-type contracts, expenses and accounts payable were recognized when disbursements were recorded in the DBMS rather than when the service was received. For 22 of the 24 transactions, the invoice or receiving report was not available from the Navy accounting office indicating that the receiving documents were not provided to the Navy accounting offices. For the other 2 transactions, receipt documents were obtained from the Navy accounting office, but the expense was not recognized until the disbursement was recorded in the DBMS.

Material Contracts. For the 9 transactions involving material purchases, the expense and accounts payable were not recorded when the material was received, although in some instances, the Navy accounting office had copies of the receiving documents. The expense was not recognized until the disbursement was recorded in the DBMS. For example, DFAS Columbus recorded a disbursement of \$5,568.15 in DBMS on April 27, 2000. The expense was also recorded at that time. However, the invoice and shipping document for the

material were dated September 14, 1999. As a result, the expense was not properly recorded within the DBMS system until 7 months after the receipt of the material.

Material Requisitions. For the 13 transactions involving \$3,000 in material requisitions, the expense and accounts payable were not recorded when the material was received. Instead, the expense was recognized when interfund billings were processed to record the related disbursement in the DBMS. Interfund billing transactions represent an automated billing and funds transfer process among Government entities that have a buyer/seller relationship. For 1 of the 13 transactions, there was no record of material receipt at the Navy accounting office. For the other 12 transactions, the Navy accounting office was provided receipt documentation; however, its personnel did not record the receipt in DBMS when the documentation was received. For example, the receiving documents for requisition number N322560032T837 were dated March 17 and March 19, 2000. However, the expense and accounts payable were not recorded based on receipt of the material. The disbursement (interfund billing) for the requisition was posted to DBMS on April 21, 2000.

Training. For the one transaction involving employee training, FISC Puget Sound did not record an obligation prior to the training and did not recognize the expense and accounts payable when the training was completed. For document number N004060TGD0060, the training invoice was dated February 7, 2000, and the class was taken from January 24 through January 28, 2000. The obligation and expense for the training was not recorded in DBMS until April 11, 2000, 3 months after the class had been completed.

Recognition of Expenses Based on Obligations. Accrual accounting procedures require that expenses should not be recognized until the expenses actually occur. Recording expenses based on obligations overstates the expenses and accounts payable. Of \$3.1 million in expense transactions, \$.2 million (6 percent) of those expenses should have been recorded in a later month.

Bulk Obligations. NAVICP Mechanicsburg recognized expenses and accounts payable prematurely when bulk obligations for subsequent credit card purchases totaling \$175,000 were recorded. By December 31, 1999, NAVICP Mechanicsburg had processed the bulk obligations using transactions that simultaneously recorded an obligation, and expense. However, no purchases were made against those funds. In May 2000, the \$175,000 was returned to the fund-holder and NAVICP Mechanicsburg recorded 2 transactions, totaling \$175,000 to reverse the expense and accounts payable. As a result, expenses and accounts payable in the general ledgers were overstated for 5 months.

Travel Authorizations. For the 13 transactions related to employee travel, the 2 Navy accounting offices recognized expenses and accounts payable when funds were obligated, prior to the performance of the travel. The FISC Puget Sound and NAVICP Mechanicsburg accounting offices commonly

recorded transactions in DBMS to recognize the commitment, obligation, and expense when the travel authorization was processed. Entering transactions in this manner created an expense and an accounts payable prior to the performance of the travel. For example, an expense for travel order number N00406TOB0173 was recorded on May 12, 2000. However, the travel for this authorization was not scheduled to occur until June 10, 2000. For 2 other travel authorizations in our sample, the planned travel was canceled; however, the expense was recorded in the general ledger for at least 1 month before the transaction was reversed. As a result, incorrect amounts were reported for expenses and accounts payable in the general ledger used to produce the monthly financial statements.

Documentation Supporting Expenses. Of the 101 expense transactions reviewed, neither of the 2 Navy accounting offices had adequate receipt documentation for 36 transactions, valued at \$2.3 million. This occurred because NAVICP Mechanicsburg and FISC Puget Sound had not established procedures and controls to ensure that the required receipt documentation was provided to the Navy accounting office. In the case of material and service contracts, the Navy accounting office was not on the distribution list for the invoices.

- For 22 expense transactions totaling \$1.6 million, the Navy accounting office did not have receiving reports or certified invoices to indicate that the material or service was received. Accordingly, we were not able to verify that the expense was recorded in the proper accounting period.
- For 14 expense transactions totaling \$.7 million, the receiving reports or certified invoices were also not available from the Navy accounting office. However, based on additional research, we found that those expenses were recorded at least 1 month after the expense was actually incurred. Therefore, those transactions were included in the \$1.3 million previously discussed as transactions recorded after the expenses were incurred.

Recognition of Expenses in the Proper Accounting Period. For 17 (\$51,387) of the 101 expense transactions, the expense was recognized in the proper accounting period. In these cases the receiving report or certified invoice was provided to the Navy accounting office and recorded in the DBMS in a timely manner. The expense transactions that were recorded in a timely manner included credit card purchases, service contracts, material contracts and material requisitions.

BMR Requirements for Recognition of Expenses and Accounts Payable

The DBMS accounting system used during FY 2000 was a legacy system and was scheduled to be replaced with the BMR system as early as October 2001. The

BMR systems requirements specifications, November 22, 2000, for expenditure capabilities require that the new system allow for on-line interface capability to post the expense. The new system will also allow for on-line input to post disbursements to a corresponding commitment/obligation, as well as allowing for multifunction transactions, such as commitment, obligation and accrual posting simultaneously. In addition, the new system will allow for an interface for travel to include the posting of the related expenses. The implementation of the BMR system will alleviate the deficiencies related to training, travel, and material requisition transactions cited in this finding. Therefore, we are not making any recommendations related to the processing of those transactions. However, because the new system will allow these new posting and multifunction transaction capabilities, the Navy accounting offices will need to establish procedures and strengthen management controls to ensure that transactions are recorded at the time the expense occurs. To help strengthen controls, the BMR system should be modified to generate reports identifying untimely expense recognition in order for the Naval Supply Systems Command and WCF organizations to monitor the organizations' internal controls over receipt processing.

Summary

FISC Puget Sound and NAVICP Mechanicsburg accounting offices' procedures and controls over the recording of receipt of material and services were inadequate. Our sample included only 2 of the 12 Navy WCF organizations using the DBMS. However, the large percentage of expenses recorded based on the wrong criteria leads to questions of the overall reliability of reported expenses and accounts payable. Expense and accounts payable recognition did not comply with the accrual accounting principles set forth in the DoD accounting policy. In some cases, the improved system requirements and interfaces, as outlined in the BMR system requirements, should alleviate the cited deficiencies. However, the BMR system will not require the expense and accounts payable to be recorded in the system prior to posting of the disbursement. In addition, the BMR system will permit the Navy WCF organizations to record obligations and expenses simultaneously. Accordingly, it is imperative that accounting organizations implement procedures outlined in DoD Regulation 7000.14-R to recognize expenses and accounts payable based on a receiving document or certified invoice rather than on a disbursement or obligation.

Recommendations and Management Comments

B.1. We recommend that the Commander, Naval Supply Systems Command, establish procedures and controls that ensure that the personnel receiving material and services provide receiving reports and certified invoices to the appropriate Navy accounting office.

Navy Comments. The Navy concurred and will provide direction to its field organizations using DBMS to establish procedures and controls to ensure expenses and accounts payable are posted in the period incurred. The action will be completed by July 31, 2001.

B.2. We recommend that the Commander, Naval Supply Systems Command, require Navy accounting offices using the Defense Business Management System, and the Business Management Redesign system in the future, to post expense and accounts payable transactions in the period incurred based on receiving documents and invoices in accordance with DoD Regulation 7000.14-R.

Navy Comments. The Navy concurred and will provide direction to its field organizations using DBMS and applicable follow-on systems to establish procedures and controls to ensure that expense and accounts payable transactions are posted within the period incurred based on information received. This action will be completed by July 31, 2001.

B.3. We recommend that the Director, Defense Finance and Accounting Service, direct the Business Management Redesign project office to incorporate a requirement in the Business Management Redesign system to generate management reports to the Naval Supply Systems Command and Navy Working Capital Fund organizations for monitoring the timeliness of the recording of expenses and accounts payable within the system.

DFAS Comments. DFAS concurred and stated that the Business Management Redesign has incorporated requirements to generate management reports for monitoring the timeliness of recording expenses and accounts payable within the system.

Appendix A. Audit Process

Scope

Work Performed. We reviewed the DBMS processes and the DFAS Columbus procedures for calculating revenue from reimbursable orders. In addition, we reviewed Navy WCF procedures and controls over recording expenses in the DBMS. We judgmentally sampled 105 revenue transactions and 101 expense transactions recorded in the DBMS from FISC Puget Sound and NAVICP Mechanicsburg during May 2000.

Limitations to Audit Scope. We excluded personnel expenses from the scope of our review. Personnel costs represented \$413 million of the \$1.2 billion in operating expenses reported from DBMS during FY 2000.

DoD-Wide Corporate-Level Government Performance and Results Act Coverage. In response to the Government Performance and Results Act, the Secretary of Defense annually establishes DoD-wide corporate level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following objective and goal, subordinate performance goal, and performance measures.

FY 2001 DoD Corporate-Level Goal 2: Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military Affairs, and reengineer the Department to achieve a 21st century infrastructure. **(01-DoD-02)**

FY 2001 Subordinate Performance Goal 2.5: Improve DoD financial and information management. **(01-DoD-2.5)**

FY 2001 Performance Measure 2.5.1: Reduce the number of noncompliant accounting and finance systems. **(01-DoD-2.5.1.)**

FY 2001 Performance Measure 2.5.2: Achieve unqualified opinions on financial statements. **(01-DoD-2.5.2.)**

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objective and goal.

Financial Management Area. Objective: Strengthen internal controls. **Goal:** Improve compliance with the Federal Managers' Financial Integrity Act. **(FM-5.3)**

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in the DoD. This report provides coverage of the Defense Financial Management high-risk area.

Methodology

We reviewed transactions at the field activity level for both proper recording in the DBMS and compliance with DoD Financial Management Regulation guidance. Supporting source documentation for each transaction was obtained from the responsible Navy accounting office.

Use of Computer-Processed Data. We relied on computer-processed data from the DBMS to evaluate the flow of data from source transactions to the General Ledger Account Codes within the DBMS. We did not evaluate the general or application reviews over the DBMS. We concluded that the data were sufficiently reliable to meet the audit objective. Not evaluating the controls did not affect the results of the audit.

Universe and Sample Selection. We obtained May 2000 transaction data for the 12 Navy WCF organizations being serviced by DFAS Columbus and using the DBMS. Total revenue and operating expenses reported from the DBMS for May 2000 was \$21 million and \$97.5 million, respectively. We excluded personnel related operating expenses totaling \$35.6 million from the scope of our review due to the relatively low risk related to those types of transactions. Non-personnel related operating expenses reported by the DBMS totaled \$61.9 million. Two Navy accounting offices, FISC Puget Sound and NAVICP Mechanicsburg were selected for audit based on the dollar amount of revenues and expenses reported for May 2000. The universe for the 2 organizations consisted of 23,619 revenue transactions valued at \$9.3 million and 6,375 expense transactions (excluding personnel expenses) valued at \$9.4 million. For those 2 Navy WCF organizations, we judgmentally selected 101 expense transactions, valued at \$3.1 million, and 105 revenue transactions, valued at \$4.0 million, based on the dollar value of the transactions and the number of occurrences of the transaction type.

Audit Type, Period, and Standards. We performed this financial-related audit from June 2000 through February 2001, in accordance with auditing standards issued through the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included tests of management controls considered necessary.

Contacts During the Audit. We visited or contacted individuals and organizations in the DoD. Further details are available on request.

Management Control Program Review

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the management controls.

Scope of Review of the Management Control Program. We reviewed the adequacy of DFAS Columbus management controls over the processing of accounting entries to financial data within the DBMS. In addition, we reviewed controls in place at FISC Puget Sound and NAVICP Mechanicsburg for the recording of revenues and expenses within the DBMS. We reviewed management's self-evaluation applicable to those controls.

Adequacy of Management Controls. We identified material control weaknesses as defined by DoD Instruction 5010.40. Management controls at DFAS Columbus did not ensure that revenue was recognized in the proper accounting period. In addition, management controls at FISC Puget Sound and NAVICP Mechanicsburg did not ensure that expenses were recorded when services and materials were received. DFAS Columbus is in the process of replacing the DBMS with the BMR system. The BMR system provides for interfaces with feeder systems including logistics, travel and purchase card systems, which should improve the recognition of expenses. Recommendations A.1. and A.2., if implemented, would ensure that the recognition of revenue by the DBMS complied with DoD accounting policy. Recommendations B.1., B.2., and B.3., if implemented, would result in the timely recognition of expenses in the DBMS, and provide management visibility to the accounting organizations that do not record expenses when material and services are received. A copy of the report will be sent to the senior management officials in charge of management controls.

Adequacy of Management's Self-Evaluation. DFAS Columbus officials did not identify the recognition of revenues and expenses within the DBMS as an assessable unit; therefore, it did not identify or report the material management control weaknesses identified by this audit. In addition, FISC Puget Sound and NAVICP Mechanicsburg did not identify the lack of standard operating procedures for processing of data within the DBMS as an assessable unit or a material management control weakness.

Adequacy of Management's Assessment of Accounting Systems. The DBMS System Manager/User Review for FY 2000 was not completed because DBMS is scheduled for replacement in FY 2001. The DFAS Columbus FY 1998 System Manager/User Review of DBMS reported that the system was not in compliance with all of the key accounting requirements. The principal deficiency identified was that the U.S. standard general ledger account structure was not used.

Prior Coverage

The General Accounting Office and the Inspector General, DoD, have conducted multiple reviews related to financial statement issues. General Accounting Office reports can be accessed on the Internet at <http://www.gao.gov>. Inspector General, DoD, reports can be accessed on the Internet at <http://www.dodig.osd.mil/audit/reports>. Naval Audit Service reports can be accessed on the Internet at <http://www.hq.navy.mil/naualaudit>.

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Naval Inspector General
Auditor General, Department of the Navy
Commander, Naval Supply Systems Command

Department of the Air Force

Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Finance and Accounting Service
Director, Defense Finance and Accounting Service, Cleveland
Director, Defense Finance and Accounting Service, Columbus

Non-Defense Federal Organization

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency, Financial Management, and
Intergovernmental Relations, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations,
Committee on Government Reform
House Subcommittee on Technology and Procurement Policy, Committee on
Government Reform

Department of the Navy Comments



DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(FINANCIAL MANAGEMENT AND COMPTROLLER)
1000 NAVY PENTAGON
WASHINGTON, D.C. 20350-1000

APR 10 2001

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

Subj: DRAFT AUDIT REPORT ON RECOGNITION OF REVENUES AND
EXPENSES IN THE DEFENSE BUSINESS MANAGEMENT SYSTEM
(PROJECT NO. D2000FC-0279.003)

Ref: (a) DODIG memo of 6 Feb 01

Encl: (1) DON Comments on DODIG Draft Audit Report

By reference (a), you requested comments regarding the
subject draft report. Comments are provided in enclosure (1).

The point of contact for this matter is Mr. Edward Johnson
at (202) 685-6703.

A handwritten signature in cursive script, reading "Gladys J. Commons", is positioned above the typed name.

GLADYS J. COMMONS
Principal Deputy
Assistant Secretary of the Navy
(Financial Management and Comptroller)

Copy to:
DFAS
DFAS-CL
NAVINSGEN
COMNAVSUPSYSCOM

**DEPARTMENT OF THE NAVY COMMENTS
ON
DODIG DRAFT AUDIT REPORT OF 6 FEBRUARY 2001
"RECOGNITION OF REVENUES AND EXPENSES IN THE DEFENSE BUSINESS
MANAGEMENT SYSTEM
(PROJECT NO. D2000FC-0279.003)**

Finding A: Recognition of Revenue and Accounts Receivable.

Recommendation for Corrective Action

1. We recommend the Director, Defense Finance and Accounting Service (DFAS), with assistance from the Assistant Secretary of the Navy, Financial Management and Comptroller, establish interim procedures to recognize revenue recorded in the Defense Business Management System (DBMS) in accordance with the Department of Defense (DoD) Financial Management Regulations.

Department of the Navy Comment

Concur in principle. We will provide the necessary support as requested by the DFAS to develop interim procedures for the recognition of revenue in the DBMS. Implementation of any interim procedures must consider the impact on workload, and the future deployment of the Business Management Redesign System.

Finding B: Accrual of Expenses and Accounts Payable

Recommendation for Corrective Action

1. We recommend that the Commander, Naval Supply Systems Command (COMNAVSUPSYSCOM), establish procedures and controls that ensure that the personnel receiving material and services provide receiving reports and certified invoices to the appropriate Navy accounting office.

Department of the Navy Comment

Concur. COMNAVSUPSYSCOM will provide direction to all subordinate field activities utilizing the DBMS to establish procedures and controls to ensure that personnel receiving material and services provide receipt and certification data to the funds administrator to allow for timely and accurate posting of receipt/accounts payable transactions. This action will be completed by 31 July 2001.

Enclosure (1)

Recommendation for Corrective Action

2. We recommend that the COMNAVSUPSYSCOM, require Navy accounting offices using the DBMS, and the Business Management Redesign system in the future, to post expense and accounts payable transactions in the period incurred based on receiving documents and invoices in accordance with DoD Regulation 7000.14-R.

Department of the Navy Comment

Concur. COMNAVSUPSYSCOM will provide direction to all subordinate field activities utilizing the DBMS, and applicable follow-on systems, to establish procedures and controls to ensure that expense and accounts payable transactions are posted in the period incurred, within automated system parameters, based on receiving documents and invoices in accordance with DoD Regulation 7000-.14-R. This action will be completed by 31 July 2001.

Defense Finance and Accounting Service Comments



DFAS-DAS

DEFENSE FINANCE AND ACCOUNTING SERVICE

1931 JEFFERSON DAVIS HIGHWAY
ARLINGTON, VA 22240-5291
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APR 10 2001

MEMORANDUM FOR DIRECTOR, FINANCE AND ACCOUNTING DIRECTORATE,
OFFICE OF THE INSPECTOR GENERAL, DEPARTMENT OF
DEFENSE

SUBJECT: Audit Report on Recognition of Revenues and Expenses in the Defense Business
Management System (Project No. D2000FC-0279.003)

Our response to the subject audit is attached. The point of contact is Mr. David Arvin,
(703) 607-2857 or DSN 327-2857.


Robert F. McNamara
Director for Accounting

Attachment:
As stated

cc:
DFAS-DDI
DFAS-AA/CA
DFAS-AAD/CL

DFAS Comments on Audit Report on Recognition of Revenues and Expenses in the Defense Business Management System (Project No. D2000FC-0279.003)

General Comments: The subject report indicates that the recording of revenues, accounts receivable, expenses and accounts payable in the Defense Business Management System (DBMS) does not comply with Department of Defense (DoD) accounting policy. The noncompliance is due partially to deficiencies inherent in DBMS. In this case, DBMS records earnings by matching obligations to job orders instead of recognizing revenue when services have been performed. The Business Management Redesign (BMR) has been earmarked to replace DBMS. The BMR should incorporate the functionality of DBMS and related suites of systems and remedy many known accounting deficiencies.

Responses to Recommendations

Recommendation A1: We recommend that the Director, Defense Finance and Accounting Service, with assistance from the Assistant Secretary of the Navy, Financial Management and Comptroller, establish interim procedures to recognize revenue recorded in the Defense Business Management System in accordance with the DoD Financial Management Regulation.

Management Comments: Concur. Navy Working Capital Fund reports cost using a reimbursable job order process. Labor revenues are properly generated at the time of expense in accordance with the DoD Financial Management Regulation (FMR). DBMS generates nonlabor revenue at the time of obligation rather than recording the expense when a reimbursable job order process is employed. DFAS will work with the Office of the Assistant Secretary of the Navy (Financial Management and Comptroller) to revise current business practices or to develop interim procedures to ensure that revenues are properly recorded in DBMS in accordance with the DoD FMR. DFAS Columbus and our Navy partners will develop a plan of action and milestones (POA&M) to implement the changes. The estimated completion date for identifying the required changes is July 31, 2001. The estimated completion date for the POA&M is September 30, 2001.

Estimated Completion Date: September 30, 2001.

Recommendation A2: We recommend that the Director, Defense Finance and Accounting Service, ensure that the new Business Management Redesign System, when fielded, has appropriate procedures and controls to recognize revenue during the period the revenue was earned.

Management Comments: Concur. The requirements for the BMR include appropriate procedures and controls to recognize revenue during the period it is earned. The BMR, when fielded, will recognize revenue during the period the revenue is earned. The recognition of revenue will be based on the recognition of the expense for all labor and nonlabor categories for activities using job orders to accumulate revenue.

Estimated Completion Date: Actions to ensure that the new BMR system, when fielded, has appropriate procedures and controls to recognize revenue during the period the revenue is earned are complete. However, the details of the BMR deployment have not been determined.

Recommendation B3: We recommend that the Director, Defense Finance and Accounting Service, direct the Business Management Redesign project office to incorporate a requirement in the Business Management Redesign system to generate management reports to the Naval Supply Systems Command and Navy WCF organizations for monitoring the timeliness of the recording of expenses and accounts payable within the system.

Management Comment: Concur. The BMR has incorporated requirements to generate management reports for monitoring the timeliness of recording expenses and accounts payable within the system. The BMR, when implemented, will generate management reports to the Naval Supply Systems Command and Navy Working Capital Fund organizations for monitoring the timeliness of the recording of expenses and accounts payable within the system.

Estimated Completion Date: Actions to incorporate a requirement in the BMR system to generate management reports for monitoring the timeliness of the recording of expenses and accounts payable within the system are complete. However the details of the BMR deployment have not been determined.

Audit Team Members

The Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report. Personnel of the Office of the Inspector, DoD, who contributed to the report are listed below.

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